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IN THE

Supreme Court of the United States

MEADWESTVACO CORPORATION,
successor in interest to THE MEAD CORPORATION,
Petitioner,

v.

ILLINOIS DEPARTMENT OF REVENUE, DIRECTOR OF THE ILLINOIS DEPARTMENT OF REVENUE, and TREASURER OF THE STATE OF ILLINOIS,
Respondents.

On Writ of Certiorari to the Appellate Court of Illinois

BRIEF OF *AMICI CURIAE* COUNCIL ON STATE TAXATION AND NATIONAL ASSOCIATION OF MANUFACTURERS IN SUPPORT OF PETITIONER

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BRIEF OF *AMICI CURIAE* COUNCIL ON STATE TAXATION AND NATIONAL ASSOCIATION OF MANUFACTURERS IN SUPPORT OF PETITIONER

INTEREST OF *AMICI CURIAE*

This brief *amici curiae* in support of petitioner ("Mead") is filed on behalf of the Council On State Taxation ("COST") and the National Association of Manufacturers ("NAM").[1]

[1] The parties have consented to the filing of this brief. Counsel of record for all parties received notice at least 10 days prior to the due date of the *amici curiae*'s intention to file this brief. No counsel for a party authored this brief in whole or in part,

COST is a non-profit trade association formed in 1969 to promote equitable and nondiscriminatory state and local taxation of multi-jurisdictional business entities. COST represents nearly 600 of the largest multistate businesses in the United States; companies from every industry doing business in every state. COST's members are concerned that Illinois' effort to tax the gain on the sale of a non-unitary, non-operational line of business will subject taxpayers to inconsistent and unconstitutional taxation. COST's members are also concerned that left unchecked Illinois' approach to taxing all income will lead other states to adopt similarly unsound theories of taxation, exacerbating multiple taxation of the same income.

NAM is the nation's largest industrial trade association, representing small and large manufacturers in every industrial sector and in all 50 states. The NAM's mission is to enhance the competitiveness of manufacturers by shaping a legislative and regulatory environment conducive to U.S. economic growth and to increase understanding among policymakers, the media and the general public about the vital role of manufacturing to America's economic future and living standards.

The Court has granted *certiorari* on this important case to review whether Illinois can tax the gain on Mead's sale of its investment in Lexis/Nexis, a non-unitary business that Mead held for investment purposes for twenty-six years. *Amici* represent multi-jurisdictional businesses that routinely hold invest-

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and no person or entity other than *amici curie*, their members, or their counsel has made a monetary contribution to the preparation or submission of this brief.

ments they neither closely manage nor incorporate into the unitary operations of the businesses. The frequency of these transactions and the large dollar amounts at stake (in this case a $1 billion gain) hyper-accentuate the importance of the rules for determining whether gains on such sales are apportionable income subject to tax by non-domiciliary jurisdictions. Certainty and protection against multiple taxation of such gains are critically important issues to all of *Amici*'s membership. *Amici*'s members have a strong interest in the Court standing beside what it has previously held to be allocable income that cannot be taxed by non-domiciliary jurisdictions.

STATEMENT OF THE CASE

Mead is in the business of producing and selling paper and packaging products along with office and school supplies. It was incorporated and commercially domiciled in Ohio. In 1968, Mead invested in Data Corporation by purchasing it for $6 million. In 1973, Data Corporation was transformed into Lexis and at that time it began providing electronic legal research at the national level. Nexis, a news and information service, was subsequently added to form Lexis/Nexis.

At various times Lexis/Nexis operated as a division or a subsidiary of Mead. Regardless of how Mead structured its Lexis/Nexis investment, Lexis/Nexis always maintained separate business operations, personnel and made no joint purchases with Mead. In December 2004, Reed Elsevier, P.L.C. bought Mead's Lexis/Nexis investment for approximately $1.5 billion.

Mead and its subsidiaries filed an Illinois combined unitary income tax return for the 2004 year reporting

that the $1 billion gain from its sale of Lexis/Nexis was nonbusiness income not allocable to Illinois. The Illinois Department of Revenue audited Mead's 1994 return and asserted that Mead's gain from the sale of Lexis/Nexis should be treated as business income subject to apportionment.

At the trial level, the Circuit Court of Cook County held that Mead and Lexis/Nexis were not unitary. However, the Circuit Court of Cook County held that Mead must apportion the gain because Lexis/Nexis served an operational purpose. On appeal to the Appellate Court of Illinois, First Judicial District, affirmed the Circuit Court of Cook County. Mead requested a Petition for Leave to Appeal with the Supreme Court of Illinois, which was denied on January 24, 2007.

This Court granted *certiorari* on September 25, 2007 to address the following question: Is the attempt by Illinois to tax the approximately $1 billion gain realized by Petitioner when it sold its interest in Lexis/Nexis in 1994 (which it acquired in 1968 for $6 million and which functioned for 26 years as an independent, nonunitary business) in direct conflict with the decisions of the Court in *Allied Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768 (1992), *F.W. Woolworth Co. v. Taxation & Revenue Department of New Mexico*, 458 U.S. 354 (1982) and *ASARCO Inc. v. Idaho State Tax Commission*, 458 U.S. 307 (1982) and the Due Process and Commerce Clauses of the United States Constitution?

SUMMARY OF ARGUMENT

In the shaping decision of *Allied-Signal v. Director, Division of Taxation*, 504 U.S. 768 (1992), this Court contoured the outer reach of a state's ability to tax

multijurisdictional income to only those activities that bear a substantial relationship to the operations of the investor corporation in the state. The decision of the Appellate Court of Illinois severely undermines the *Allied-Signal* standard, exposing companies to extraterritorial taxation and unlimited apportionment.

Against the precedent established by this Court in *Allied-Signal,* Illinois is asserting that it can apportion investment income to the state that is not derived from a business's unitary operations. Income that serves an investment purpose must be allocated to Mead's commercial domicile, Ohio, and cannot be taxed by states in which Mead is carrying on its unrelated operations. As stated by this Court in *Allied-Signal*, "[s]tate legislators have relied upon our precedents by enacting tax codes which allocate intangible nonbusiness income to the domiciliary State . . . [w]ere we to adopt New Jersey's theory, we would be required either to invalidate those statutes or authorize what would be certain double taxation." *Id.* at 785. If the Illinois case is left unfettered, the Constitutional limitations described in *Allied-Signal* will be ignored and states will be free to tax income earned outside their borders. The Court espoused in *Quill v. North Dakota*, 504 U.S. 298 (1992), "the benefits of a clear rule . . . firmly establishes the boundaries of legitimate state authority to impose . . . taxes and reduces litigation concerning those taxes." Absent such a rule, interstate commerce will suffer grievous harm. *Id.* at 315.

ARGUMENT

I. *ALLIED-SIGNAL'S* OPERATIONAL VERSUS INVESTMENT FUNCTION TEST APPLIES ONLY IN THE CONTEXT OF NON-CONTROLLED BUSINESSES

The taxation of multistate activity, and in particular the rules by which non-domiciliary states may tax income from the liquidation or sale of major assets, has routinely attracted the attention of this Court. *See, e.g.*, *Allied-Signal*, 504 U.S. 768; *ASARCO Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307 (1982); *F.W. Woolworth Co. v. Taxation & Revenue Dep't of the State of New Mexico*, 458 U.S. 354 (1982). This Court's previous guidance establishes the Constitutional boundaries for fair taxation of businesses whose activities cross state lines. By doing so, the Court has carefully crafted a set of rules that protect interstate commerce from discrimination and that provide clear guidance such that state and local taxes do not unlawfully impede economic growth. While the scope of the Constitutional limits on state taxation was not always clear, this Court brought a measure of certainty to the arena of state tax in the seminal case of *Mobil Oil Corp.* v. *Commissioner of Taxes of Vermont*, 445 U.S. 425, 439 (1980), where it clarified that "[The] linchpin of apportionability in the field of state income taxation is the unitary business principle." *See also Exxon Corp. v. Department of Revenue of Wisconsin*, 447 U.S. 207 (1980).

Two years after *Mobil Oil*, the concept of the unitary business enterprise was further clarified in two cases decided on the same day, *ASARCO Inc. v. Idaho State Tax Commission*, 458 U.S. 307 (1982) and *F. W. Woolworth Co. v. Taxation & Revenue Department of New Mexico*, 458 U.S. 354 (1982). In

these two decisions the Court struck down attempts by two states to tax an apportioned share of income, which was—similar to the present case—derived from a non-unitary business. In reaching its decision the Court indicated that actual, and not merely potential, control of another enterprise is required to establish a unitary relationship, and further emphasized that a unitary inquiry requires a review of three factors: "(1) functional integration; (2) centralization of management; and (3) economies of scale." *Id.* at 362, 364.

When read together, these cases establish an overarching policy that binds the apportionability of income directly to whether the income stems from a unitary function of the business sought to be taxed. In other words, a state need not attempt to isolate the intrastate income-producing activities from the rest of the business; it may tax an apportioned sum of the corporation's multistate business if the business is unitary.

Ten years after *ASARCO* and *Woolworth*, and in response to an argument by New Jersey that all income was subject to apportionment, this Court upheld the unitary principle, acknowledging that some income from a nonunitary enterprise might be apportionable—if "the capital transactions serve an operational rather than an investment function." *Allied-Signal v. Director, Div. of Taxation*, 504 U.S. 768, 787 (1992).[2] The Court first articulated the application of

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[2] In *Allied-Signal*, this Court specifically declined the invitation of the State of New Jersey that "the unitary business principle must be abandoned in its entirety, arguing that a nondomiciliary State should be permitted 'to apportion all the income of a separate multistate corporate taxpayer.'" *Allied-Signal* at 784. The Court rejected the idea that all income of an enterprise should be taxable in every state; an idea which it

an operational function concept to state tax apportionment regimes in *Container Corp. of America v. Franchise Tax Board.*, 463 U.S. 159 (1983). In *Container Corp.*, the Court examined the sole issue of whether a unitary relationship existed between wholly-owned entities. The Court cited *Corn Products Co. v. Commissioner*, 350 U.S. 46 (1955), as an example, "in another context," of how "capital transactions can serve either an investment function or an operational function." *Container Corp.*, 463 U.S. at 180 n.19. Although the *Container Corp.* footnote discusses what would later evolve into the operational function test in *Allied-Signal*, the issue in *Container Corp.* related solely to the unitary business. *See id.* at 178 (observing that the parent and subsidiary were "engage[d] in the same line of work" so that the subsidiary supported the parents "through economies of scale or through operational integration or sharing of expertise").

The lineage of the operational function test suggests that the sale of a nonunitary asset may satisfy the operational function test only where a taxpayer has the ability to control the nonunitary asset but does not. *Allied-Signal*, *Woolworth*, and *ASARCO* support such a conclusion. The Court in *Allied-Signal* analyzed a "capital transaction," that "serve[s] an operational rather than an investment function." *Allied-Signal*, 504 U.S. at 787. Allied-Signal owned 20.6% of the business it sold. As such, it did not control the sold business and, as a result, did not have a unitary relationship with the sold business. Nevertheless, this Court made clear that the absence of control did not prevent a finding that Allied-

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acknowledged would obliterate the apportionable income concept. *Id*

Signal's gain was apportionable income. The operational versus investment function test was applied by this Court *only* in the circumstance where control did not exist. *Compare Allied-Signal*, 504 U.S. at 773 (applying operational functional test where 20.6% ownership) *with ASARCO Inc. v. Idaho State Tax Commission,* 458 U.S. 307 (1982) and *F. W. Woolworth v. Taxation & Revenue Department of New Mexico,* 458 U.S. 354 (1982) (applying only a unitary analysis where ownership was 100%).

Thus, this Court should make clear that the operational versus investment function test applies only in those narrow circumstances where the ability to control a nonunitary business is absent. Such ability to control is present here and the test should not be applied.

II. THE ILLINOIS APPELLATE COURT'S MISAPPLICATION OF THE OPERATIONAL VERSUS INVESTMENT FUNCTION TEST WOULD RENDER ALL INCOME SUBJECT TO APPORTIONMENT

Even if the operational function test applies in this instance, the Illinois appellate court expanded this Court's operational function test in such a way that nearly every corporate investment will serve an operational purpose under its application. While *Allied-Signal* does not list a series of specific factors to consider under the operational test, this Court has only narrowly applied the test by focusing on whether the asset generating the income was utilized directly in the selling company's business, or whether it was utilized for investment purposes to fund the day-to-day working capital and operations of the selling company. *Id.* at 787, 789-90. Only if one of these

functions is met can the income be determined to be operational and subject to tax by a non-domiciliary jurisdiction.

The Appellate Court of Illinois erroneously adopted its own test in place of the operational analysis required by *Allied-Signal*. The Appellate Court of Illinois focused on a series of irrelevant and results-oriented factors intended to accomplish implicitly what New Jersey attempted explicitly in *Allied-Signal*—to eliminate any limitations on apportionment.

While this Court did not set forth a monolithic test in *Allied Signal* on what constitutes income from an operational function, this Court did provide one narrow example of income that serves an operational function. Interest earned on short-term deposits at a bank used for the working capital of a unitary business serves an operational function, and accordingly could be subject to apportionment. *Allied Signal* at 787.

The Court has also implied that the same holds true with long-term investments if the investment "serves the primary function of diversifying the corporate portfolio and reducing the risks inherent in being tied to one industry's business cycle." *Container Corp.*, 463 U.S. 159 at 178.

It can be inferred from *Allied-Signal* and *Container Corp.* that the narrowly crafted test for whether income was received from an operational function of the business is: (1) was the income derived from an asset that was used in the business's unitary operations or (2) was the income a component part of the business's working capital. If either of these is true, then the income serves an operational function and can be part of the corporation's unitary apportion-

ment. In contrast, if both are answered in the negative, then the income is an investment function that is only subject to taxation by the domiciliary state.

As described below, the factors utilized by Illinois to conclude that the gain was apportionable disregard the necessary operational focus this court established in *Allied-Signal*—whether the asset was used in the same line of business as the company that sold it or whether the asset was analogous to working capital. By substituting its own factors the Illinois court instead focuses the analysis on criteria that would support the conclusion that the gain on the sale of *any* business investment will be subject to apportionment. In a rather self-serving fashion, the court below evaluated factors that exist as a matter of normal business practice for nearly all corporate investments and which make the elimination of non-apportionable income a *fait accompli*.

The Opinion of the Appellate Court of Illinois ("*Op.*"), includes the following factors that, as also set out below, have no bearing on whether the asset being held is operational:

> (i) "Mead considered Lexis/Nexis in its strategic planning, particularly in the allocation of its resources." *Op.* at 117.

Strategic planning about asset holdings, including a determination of where a parent company should invest additional resources, reflects analytic thought about the asset owner's financial investment strategy and thus supports a conclusion that the corporate holding serves an investment purpose, not an operational purpose. Indeed, strategic planning about the allocation of a company's resources is a fiduciary obligation of the directors and officers of the com-

pany, and failing to undertake this responsibility could subject those leaders to shareholder suits. Giving such planning adverse state tax consequences places management in a conflicted and untenable position.

> (ii) "Mead was 100% owner of Lexis/Nexis." *Op.* at 118.

100% ownership of a subsidiary does not by itself create a unitary relationship. While the percentage of ownership is relevant in determining whether a unitary relationship exists, it does not demonstrate that the asset serves an operational purpose. Corporations buy and sell subsidiaries, assets, divisions, and lines of business every day. Some of these transactions may be for operational synergy; others serve strictly an investment purchase—to hedge against market conditions, or simply to invest excess capital. The fact that Mead owned Lexis/Nexis in its entirety for many years does not demonstrate an operational (or investment) relationship. Mead had the potential to operate Lexis/Nexis as part of its unitary business; however, Mead elected not to do so and allowed Lexis/Nexis to function both autonomously and independently from itself, see *Woolworth*, 458 U.S. 358 at 364.

> (iii) "Mead developed Lexis/Nexis by contributing capital support until it became profitable." *Op.* at 118.

This factor is irrelevant; it does not demonstrate that there was either an investment management strategy or an operational relationship. The fact that an investor would contribute additional working capital to one of its corporate holdings demonstrates sound investment management designed to guard the investment from capital shortfalls or promote the

growth of that investment. It is normal when investing in a new business for the investment to take several years before it can sustain itself and, hopefully, become a profitable investment. In the interim period, it is not unusual for an investor to have to contribute additional capital to keep the investment in the business afloat or to increase one's overall return. Thus, Mead's investment strategy to infuse capital into Lexis/Nexis until it became profitable mirrors and is completely compatible with the investment serving an investment function for Mead. In addition, proper fiduciary management of investments requires that they be adequately capitalized; often the success or failure of an investment depends on its capitalization.

> (iv) "Mead continued to approve major capital expenditures by Lexis/Nexis." *Op.* at 118.

The fact that an investor retains decision-making power over major capital expenditures again demonstrates sound investment management designed to ensure that the investment owner's interests are adequately protected. As stated above, this point was also rejected by this Court in *Woolworth*. Absent an exertion of actual control by Mead, Mead's ability to exert its potential control over Lexis/Nexis operations did not equate into Mead's investment in Lexis/Nexis turning Lexis/Nexis into a part of the unitary enterprise and did not convert Lexis/Nexis into an operational function. Occasional oversight in an investment also does not destroy the investment nature of a business. Certainly, investors have a right, if not a duty, to verify management is making sound business decisions.

(v) Mead "manipulated Lexis/Nexis' business organization, treating it as either a division or a corporate subsidiary". *Op.* at 118.

Companies across the country routinely change their corporate structure to account for market changes. The tax and non-tax related reasons for routine changes in corporate structure are nearly infinite. The fact that Lexis/Nexis at the time Mead disposed of its investment in Lexis/Nexis operations was a division of Mead is also not a determining factor to allow Illinois to apportion the gain from Mead's sale of Lexis/Nexis. As stated by the Court in *Mobil*, 445 U.S. at 440, citing *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435 at 444, "At the onset, we reject the suggestion that anything is to be gained by characterizing receipt of the dividends as a separate taxable event . . . [such] tags of this kind are not instruments of adjudication but statements of result" (internal quotes omitted).

The Court went on further to state in *Mobil*, 445 U.S. 425 at 440, that "One most look principally at the underlying activity, not the form of investment, to determine the propriety of apportionability." The Court stated, "[T]he form of business organization may have nothing to do with the underlying unity or diversity of [the] business enterprise." *Id.* at 440. See also *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159 at 168.

This conclusion is important because in today's business environment businesses choose many different ways of owning their investments. Whether the return on an investment is from a subsidiary, a division, a partnership, or some other form of ownership, the determination regarding whether the

income from the investment necessitates apportionment or allocation should be the same.

> (vi) "Mead retained tax benefits and control over Lexis/Nexis' excess cash." *Op.* at 118.

It should be understood that investors put their money in investments with the goal of retaining tax benefits and excess cash produced by the investment. A test on whether income serves an operational or investment function based on a business having some tax benefits (or detriments) is plainly erroneous. Such a test must focus on how the property was used. If the tax benefit is derived from assets used in the business's unitary operations, clearly that is income subject to apportionment by a non-domiciliary state. However, as in Mead's situation, where the asset generating the income is not part of its unitary group or otherwise used to support its unitary operations, the income is solely serving an investment function. This position is also supported by the Supreme Court of California in its analysis of cases from California's State Board of Equalization, See *Hoechst Celanese Corp. v. Franchise Tax Board*, 22 P.3d 324 at 341-342 (Cal.), *cert denied*, 534 U.S. 1040 (2001).

> (vii) Mead, in its 1993 annual report, "identified itself as 'the developer of the world's leading electronic information retrieval services for law, patents, accounting, finance, news and business information'"; and, in its "1993 10-K form, Mead described itself as engaged in electronic publishing and included Lexis/Nexis in its discussion of business segments rather than its 'investees.'" *Op.* at 118.

Corporate Annual Reports and 10-K's aim to provide shareholders with information about the company itself as well as information about all of its

investment holdings. The fact that the Annual Report and 10K identified the company "itself" as being in the electronic information business is simply a reflection of the fact that the report discloses all signif ant holdings, divisions and lines of business of the combined group of related entities. This cannot be a factor in determining whether the corporate holding is operational.

The factors used by the Illinois court, when taken together, describe activities that any investor would sensibly conduct to protect asset value. As such, those factors blur the operational analysis inextricably with investment function analysis. At the heart of the Illinois court's faulty "operational" analysis, in light of common investment practices, is a goal of subjecting multi-jurisdictional businesses gains from the sale of *any* investment to apportionment by a multitude of non-domiciliary states if such states can show that the investor: (1) exercised normal due diligence; (2) had the mere potential to exercise some level of control; (3) engaged in strategic planning; (4) continued expansion of the investment if necessary; (5) controlled how the investment is held or titled; (6) decided whether to retain tax benefits or excess cash created by the investment; and, (7) worst of all, if the investor managed to do well by the investment and noted that fact in its Annual Report or 10-K.

The "operational" activities that Illinois considers relevant are synonymous with normal investment practices reflecting the due diligence necessary to protect and nurture the value of any investment. This type of stewardship is not symptomatic of the control and utilization inherent in the operational relationship required by *Allied-Signal*. Illinois should

not be allowed to blur operational analysis simply by substituting factors that demonstrate sound investment practice. To do so obliterates the operational standard altogether and will have the effect of subjecting investment gains from non-unitary holdings to multiple and discriminatory taxation.

Clear guidance from the Court is requested to prevent unfair and duplicative taxation by the states of the same income. This is not only an important issue to businesses to correctly determine their tax liabilities and properly report their finances, but it is also vital to the state and local governments to have some certainty with their revenue streams. As the Court has heeded in the past, it does not want to "disrupt settled expectations in an area of law in which the demands of the national economy require stability." *Allied-Signal* at 786. Illinois' determination that Mead's investment in Lexis/Nexis served an operational function effectively eviscerates the concept of some income having an investment function.

The Court's clear guidance in this area is of additional import because several states, including Illinois, have taken positions that all income will be subject to apportionment to the full extent allowed under the United States Constitution. According to a chart for determining nonbusiness income published by CCH Incorporated, presently three states have laws that explicitly require the apportionment of all income earned by a business to the greatest extent possible under the United States Constitution.[3] This

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[3] *Determining Nonbusiness Income*, Multistate Charts (CCH-EXP) ¶600-320, *available at* CCH Tax Research, State Tax-Multistate Publication-Multistate Quick Answer Charts. Those states are Illinois, Minnesota, and North Carolina. Three other

Court has established limits to a state's power to tax income that is not unitary to a company's operations and which does not serve an operational function. To maintain stability and predictability in knowing what income can be apportioned, the Court should reverse Illinois' determination that the gain from the sale of a long-term investment in Lexis/Nexis served an operational function.

CONCLUSION

Illinois' attempt to undermine *Allied-Signal* must be halted by this Court. *Allied-Signal* provides the outer limits on the income derived from a non-unitary operation that a state can tax based on a substantial connection to the unitary operations of the business. Clear guidance is also needed to prevent future interpretations by non-domiciliary states asserting they can tax income from a non-unitary operation that does not serve an operational function to the unitary business.

RELIEF REQUESTED

The Council On State Taxation and the National Association of Manufacturers respectfully requests that this Court reverse the decision of the Appellate Court of Illinois, First Judicial District. This Court's guidance on what income a state can tax on an apportioned basis versus allocation to the state of commercial domicile will prevent businesses from multiple taxation of the same income.

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states with similar laws that presume all income should be apportioned are Connecticut, Nebraska and New Hampshire.

Respectfully submitted.

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